INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
October 9, 1998

Index (UIL) Numbers: 404.04-00; 404.10-00; 404.11-00

CASE MIS Number: TAM-109038-98
CC:EBGO:B4
District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Company =

ISSUE:

Whether section 404(a)(5) of the Internal Revenue Code and section 1.404(b)-1T of the Temporary Income Tax Regulations require that compensation paid under Company's Performance Unit Plan (Plan) be deducted only in the taxable year in which or with which ends the taxable year of its employees in which the compensation was includible in their gross incomes.

FACTS:

During the taxable years at issue, Company, an accrual basis taxpayer with a taxable fiscal year ending August 31, maintained an executive compensation program that included payments equal to the value of vested performance units (units) issued under the Plan.

The Plan was intended to motivate and reward executives for their contributions to Company's growth over a continuous period. Under the Plan, units were awarded to eligible employees at the discretion of a committee of the Board of Directors (committee). Eligible employees included key Company employees whose efforts could have affected Company's growth and performance and who were selected to participate in the Plan by the committee. According to the Plan Summary, the number of units awarded to an eligible employee may be influenced by factors such as individual merit, organizational level, and years of service. Units are awarded within 120 days after the close of Company's fiscal year.

The value of each unit was based on a formula contained in the Plan. This formula was equal to the earnings per share of Company's common stock for 3 years beginning with the fiscal year the unit was awarded multiplied by a performance factor based on the compound annual growth rate in the earnings per share of Company stock during the 3-year period. The value of each unit was determined at the close of the 3-year period beginning with the year in which the award was made. The value of each unit vested in the employee at the close of business on the last day of the third year of this 3-year period. The value of each unit was paid to the employee in cash within 2 ½ months after the close of the third year of the 3-year period.

If, before the vesting of units, an employee holding units ceased to be employed by Company for any reason except death, disability, or retirement, the units were forfeited. In the event of an employee's death, disability, or retirement before the vesting of any units, the committee may have, in its discretion, provided for the vesting and payment of any unvested units on an equitable basis reflecting Company's performance during the period beginning with the date of the award and ending on the date of death, disability, or retirement.

For the taxable years at issue, Company, believing that the all events and economic performance tests under section 461 of the Code were satisfied as of the close of the taxable year when units became vested, deducted the compensation paid under the Plan in accordance with its method of accounting, even though payment was not made until 2 ½ months into Company's next taxable year. The Internal Revenue Agent, believing that the compensation was deferred compensation because payment occurred more than a brief period of time following the year in which the units were granted, contends that, in accordance with section 404(a)(5) of the Code and section 1.404-1T of the regulations, Company must deduct the compensation in the taxable year following the year in which the units vested.

LAW AND ANALYSIS:

Section 461(a) of the Code provides that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Under section 1.461-1(d)(2)(i) of the regulations, a deduction is incurred and is generally taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the deduction.

According to section 461(h)(1) of the Code, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. Section 461(h)(4) further provides that the all events test is met with respect to any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy. See also section 1.461-1(a)(2)(i) of the regulations.

Section 461(h)(2) of the Code provides the rules for determining when economic performance occurs. Under section 461(h)(2)(A)(i), if the deduction arises out of the providing of services to the taxpayer by another person, economic performance occurs as such person provides the services. See also section 1.461-4(d)(2) of the regulations.

Section 404(a) of the Code provides, in part, that if contributions are paid by an employer on account of any employee under a plan deferring the receipt of compensation, such contributions or compensation are not deductible under Chapter 1 of subtitle A of the Code, but if they would otherwise be deductible, they are deductible under section 404, subject to the limitations contained in section 404.

Pursuant to section 404(a)(5) of the Code, contributions to a deferred compensation plan are deductible in the taxable year in which the contribution is includible in the gross income of employees participating in the plan (or that would be includible but for an exclusion under Chapter 1 of the Code), but in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee.

Section 1.404(b)-1T, Q&A-1, of the regulations sets out the general rule concerning the deductibility of compensation paid under a deferred compensation plan as follows:

> As amended, section 404(b) clarifies that any plan, or method or arrangement, deferring the receipt of compensation . . . is to be treated as a plan deferring the receipt of compensation for purposes of section 404(a). . .. Thus, for example, under section 405(a) . . ., a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee. . ..

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Section 1.404(b)-1T, Q&A-2(a), of the regulations, provides that a plan defers the receipt of compensation or benefits to the extent that it is one under which an employee receives compensation or benefits "more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed." Under section 1.404(b)-1T, Q&A-2(b)(1), of the regulations, a plan is presumed to defer the receipt of compensation for "more than a brief period of time to the extent that an employee receives compensation after the fifteenth day of the third calendar month following the end of the employer's taxable year in which the related services were rendered." As an example, the regulation provides that salary under an employment contract or a bonus under a year-end bonus declaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that the salary or bonus is received beyond the applicable 2 ½ month-period. See also section 1.404(b)-1T, Q&A-2(c) of the regulations.

The Conference Report provides guidance on the type of bonus at issue in this case. Conference Report No. 861, 98th Cong., 2d Sess., 1160 (1984) explains that "the conferees intend that payment of bonuses or other amounts within 2 ½ months after the close of the taxable year in which significant services required for payment have been performed is not considered a deferred compensation or deferred benefit plan (emphasis added)." In this case, services must be performed for a full 3 years before the key Company employee is entitled to payment, but significant services are still required for payment in the last year because the payment is forfeitable if they are not provided. Therefore, these payments are not deferred compensation.

The fact that an employee may receive payment prior to the expiration of the 3-year period does not change the preceding analysis. In those circumstances, the Board, in its discretion, may make payments to employees for any unvested units. In the event the Board makes payments, the related services are the services performed from the date of the award through date of death, disability, or retirement. The units are not vested until the end of this period, and payment is made within 2 ½ months of the end of the fiscal year during which death, disability, or retirement occurs. Thus, any payments made because of death, disability, or retirement are not deferred compensation under section 404(a)(5) of the Code.

The facts in this case are distinguishable from those in Truck and Equipment Corp. of Harrisonburg v. Commissioner, 98 T.C. 141 (1992), and in Rev. Rul. 88-68, 1988-2 C.B. 117. In Truck and Equipment Corp., the Tax Court held that an accrued year-end bonus, awarded for services performed in one year, but not paid until at least 5 months into the following year were deductible in the year of payment. According to the Tax Court, the system of bonus payments had the effect of deferring the receipt of compensation under section 404(a)(5) of the Code and section 1.404(b)-1T of the regulations because, unlike the facts in this case, payment was made more than 2 ½ months after the close of the taxable year in which the related services were performed.

In Rev. Rul. 88-68, prior to the performance of services, a company on the accrual method of accounting agreed to pay an independent contractor 25 percent of his fee in the year he performed the services (1987) and 25 percent in each of the succeeding three years. Because the 1987 payment was not received more than a brief period of time after the end of the company's taxable year in which the related services required for payment were performed, the Service held that the company could deduct it in 1987. However, the Service also held that the other three payments were a method or arrangement that had the effect of a plan deferring the receipt of compensation under section 404(a)(5) of the Code because, unlike the facts in this case, the payments were received more than a brief period of time after the end of the taxable year in which the services creating the right to the compensation were performed.

CONCLUSION:

Payments under the Plan are not deferred compensation, thus, section 404(a)(5) of the Code and section 1.404(b)-1T of the regulations do not require that compensation paid under the Plan be deducted in the taxable year in which or with which ends the taxpayer year of its employees in which the compensation was includible in their gross incomes.

CAVEAT(S)

Except as specifically ruled on above, no opinion is expressed or implied concerning the application of any other section of the Code to this transaction.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.